STATEMENT OF

DOREEN R. EBERLEY
ACTING REGIONAL DIRECTOR
ATLANTA REGIONAL OFFICE
FEDERAL DEPOSIT INSURANCE CORPORATION

on

THE COMMERCIAL REAL ESTATE MARKET

before the

CONGRESSIONAL OVERSIGHT PANEL

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Chair Warren and members of the Panel, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the condition of the commercial real estate (CRE) market in Atlanta and its impact on insured depository institutions and lending.

As you noted in your invitation letter, the real estate market in the Atlanta metropolitan area[1] has been hard hit. To date, the FDIC-insured institutions in this area have experienced their greatest losses on acquisition, development, and construction (ADC) loans, most acutely on loans for residential land development. These loans deteriorated rapidly as certain types of higher-risk mortgages became less available, housing inventory built up, and home prices began to fall. Recently, we have also started to see weakness in the Atlanta area market for other types of real estate such as office, retail, hotel, and industrial.

My testimony, will describe the factors that led to high concentrations of ADC loans in the Atlanta market, and the manner in which the subsequent decline in home prices were then closely followed by high levels of loan losses and bank failures in this market. I will also discuss how CRE properties are valued and what the risks are to banks associated with these properties. Finally, I will describe the supervisory actions regulators are taking to address these risks.

[1] Unless otherwise noted, for purposes of this testimony, the Atlanta area is defined as the Atlanta-Sandy Springs-Marietta Core Based Statistical Area (CBSA), which currently includes these 28 Georgia counties: Barrow, Bartow, Butts, Carroll, Cherokee, Clayton, Cobb, Coweta, Dawson, DeKalb, Douglas, Fayette, Forsyth, Fulton, Gwinnett, Haralson, Heard, Henry, Jasper, Lamar, Meriwether, Newton, Paulding, Pickens, Pike, Rockdale, Spalding, and Walton. Bank data for the area include the all institutions headquartered in the CBSA with total assets of less than $6 billion. There were 104 institutions meeting this definition as of September 30, 2009, which is the most current financial data available. We exclude larger institutions because we assume these would have a high percentage of loans outside the CBSA.

ADC Loan Concentrations in Atlanta

The Atlanta area was ranked first in the nation in single-family home construction each year from 1998 to 2005.[2] According to the Census Bureau, Atlanta's total population increased 25.6 percent from 2000 to 2008, making Atlanta one of the fastest growing metropolitan areas in the nation.

Another factor contributing to the increase in housing stock was the increased availability of credit for housing – especially subprime and nontraditional mortgages, which significantly expanded the pool of potential homeowners. From 2002 to 2007, the aggregate balance of privately-securitized subprime mortgages in the Atlanta area grew from $4.6 billion to $15.4 billion, and the balance of privately-securitized Alt-A loans (which includes nontraditional mortgages) grew from $1.8 billion to $16.6 billion.[3]

As a result of population growth and expanded credit availability, there was increased demand for housing stock. In response, development activity increased and many FDIC-insured institutions headquartered in the Atlanta area exhibited rapid growth in their ADC portfolios. From 2002 to 2007, the share of total assets represented by ADC loans at Atlanta-based institutions increased from 11 percent to 32 percent. At similarly-sized institutions in other metropolitan areas, the share of total assets represented by ADC loans grew from 5 percent to 12 percent. The FDIC monitored this growth of ADC loans in the Atlanta area as it occurred, and in other markets in the

[2] Mark Vitner and Yasmine Kamaruddin, Wells Fargo Securities, "Georgia Economic Outlook: October 2009."
[3] FDIC analysis of LoanPerformance Securities Database.

southeastern United States. We attributed the growth in ADC loans to a similar increase in the population and demand for housing stock. What was not readily apparent, however, was the increasing volume of subprime and nontraditional mortgage originations in these markets. These types of mortgages turned out to be a significant factor driving the construction market.

Falling home prices, and a retreat by lenders from weak lending practices that prevailed during the long expansion that preceded the crisis, have led to an oversupply of available residential lots for which there is little demand. As was the case in other markets, the Atlanta housing market began to decline in the second half of 2007, at about the same time that subprime and nontraditional mortgage originations were sharply curtailed. Subprime mortgage originations in the Atlanta area declined 82 percent from 2006 to 2007.[4] Home prices, as measured by the Case-Shiller index, have fallen over 20 percent from peak to trough. Housing starts in the market have fallen 93 percent, and single-family home sales have fallen 54 percent. Recently, both indicators posted very small gains, but it is too soon to declare that the bottom has been reached. The *Atlanta Journal-Constitution* reported last August that there were 150,000 vacant developed lots, which represented a 10-year supply at current absorption rates.[5]

The deterioration in the housing market has been reflected in the performance of ADC loans at Atlanta-area financial institutions. At the end of September, 2009, over 22 percent of ADC loans at institutions headquartered in Atlanta were noncurrent, compared

[4] FDIC analysis of LoanPerformance Securities Database.
[5] "Volume of 'subdivision' vacant lots overwhelms banks," Atlanta Journal-Constitution, August 8, 2009.

to 15 percent nationwide.[6] The weighted average annualized net charge-off rate for ADC loans was 10.8 percent at Atlanta-area institutions, compared to 6.0 percent nationwide. Most importantly, it is obvious that ADC concentrations have been a significant factor in recent bank failures. At the 25 institutions from the Atlanta area that have failed since the beginning of 2008,[7] the weighted average ADC concentration a year before failure was 384 percent of total capital. Only one of the failed institutions during this time period had ADC loans that were less than 100 percent of capital a year before failure.

Eroding credit quality of other CRE loans is an emerging risk

The downturn in other CRE prices, such as office, retail, hotel and industrial, began after the fall in home values was well underway. By some measures, however, CRE prices have suffered a sharper decline than home prices. Nationally, prices for CRE properties, as measured by the Moody's/REAL Commercial Property Price Index, have fallen over 40 percent from their peak in October 2007.

There are three main factors that influence CRE values. The first factor is the trend in property fundamentals that influence cash flow, such as rental income and vacancy rates. Lower rental rates or higher vacancies result in reduced cash flow available for debt repayment.

As of third quarter 2009, quarterly rent growth has been negative across all major CRE property types nationally for at least the last four quarters. Asking rents for all

[6] Noncurrent loans are those that are 90 or more days past due or have been placed on nonaccrual status.
[7] A total of 30 FDIC-insured institutions headquartered in Georgia have failed since the beginning of 1998. Of these, 25 were headquartered in the Atlanta metropolitan area.

major CRE property types nationally were lower on both a year-over-year and quarter-to-quarter basis. Trends in rental prices in the Atlanta area appear to have mirrored national trends, though to a lesser extent.[8]

Vacancies in rental properties are significantly higher than the national average across all major CRE property types in the Atlanta area. Retail and office vacancy rates were both 31 percent higher than the national average, industrial vacancy rates were 40 percent higher than the national average, and apartment vacancy rates were 58 percent higher than the national average. The hotel occupancy rate was 9 percent below the national average. Net absorption – or the net change in occupied space or units – has turned negative in the Atlanta market for apartments (last four quarters), hotel (last twelve quarters), industrial (last four quarters), office (last four quarters), and retail (last five quarters).[9]

The second factor influencing price is investors' required rate of return on investment. In the current environment, investors are demanding higher returns. The higher expected returns are reflected in properties' capitalization rates, or "cap rates." The cap rate is the ratio of net operating income to property value. Therefore, there is an inverse relationship between cap rates and property values; property values decline as cap rates rise. Property values could fall sharply even if there is no adverse change in cash flow. Nationally, cap rates fell through 2007, but they have since risen sharply. For example, from 1990 through 2004, the average cap rate for office properties nationwide

[8] Property and Portfolio Research
[9] Property and Portfolio Research

was 8.3 percent. However, the national average fell to 6.1 percent in 2007 and since has rebounded to 8.1 percent.[10] In the Atlanta market, office property cap rates have increased from their 2007 cyclical low of 6.5 percent to 8.8 percent, retail cap rates increased from 6.6 percent to 9.1 percent, industrial cap rates increased from 6.3 percent to 8.5 percent, and multi-family housing cap rates increased from 5.4 percent to 7.7 percent.[11]

The third factor driving CRE values is credit availability. When credit availability is reduced, that in turn reduces the pool of possible buyers, increases the amount of equity that buyers must bring to transactions, and causes downward pressure on values. During the boom years, commercial mortgage-backed securities (CMBS) grew in importance as a source of CRE financing, although FDIC-insured banks and thrifts still held the largest share of commercial mortgage debt. According to the Federal Reserve's Flow of Funds report, commercial banks and savings institutions hold just over half of commercial and multi-family mortgage loans, while CMBS issuers account for one-fourth of the total. However, CMBS issuance was virtually shut down in the last half of 2008 and all of 2009 and, at the same time, bank credit is also more difficult to get. The Federal Reserve's senior loan officer survey has reported a net percentage of respondents tightening CRE credit standards for 16 consecutive quarters.[12]

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[10] Property and Portfolio Research. Represents average of 54 largest markets.
[11] Property and Portfolio Research
[12] Board of Governors of the Federal Reserve System, "October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices."

As a result of these tightening standards and a more risk-averse posture on the part of lenders, the availability of CRE credit has been declining since the beginning of 2008. The FDIC recognizes that credit may not be readily available for CRE borrowers and we have joined the other banking agencies in issuing a statement to the industry on making loans available to creditworthy borrowers in 2008, and policy guidance on prudent CRE workouts in 2009. I will discuss these initiatives later in my testimony.

Atlanta ranks in the top ten markets across all major CRE categories, ranked by available space, and FDIC-insured institutions headquartered in Atlanta have lent a considerable sum of money against CRE properties. As of September 30, 2009, Atlanta-area institutions had total CRE loans[13] (excluding ADC) of $9.3 billion, nearly one-quarter of their total assets. Their weighted average concentration of CRE loans, including ADC, to total capital was 320 percent, versus a weighted average of 311 percent for all comparably sized institutions headquartered in metropolitan areas nationwide.

Performance of loans that have CRE properties as collateral typically lags behind economic cycles. Going into an economic downturn, property owners may have cash reserves available to continue making loan payments as the market slows, and tenants may be locked into leases that provide continuing cash flow well into a recession. However, toward the end of an economic downturn, vacant space may be slow to fill, and

[13] Includes loans secured by nonfarm, nonresidential properties; loans secured by multifamily (5 or more) properties; and loans to finance CRE, but not secured by CRE.

concessionary rental rates may lead to reduced cash flow for some time after economic recovery begins.

Performance of these loans has started to deteriorate. In Atlanta banks, for the largest category of CRE loans – those with nonfarm, nonresidential properties as collateral – the aggregate noncurrent rate was 3.58 percent as of September 30, 2009, and the annualized charge-off rate was 0.52 percent. These are comparable to the aggregate noncurrent and charge-off rates for all institutions nationwide, which are 3.58 percent and 0.62 percent, respectively.

FDIC Response to Risks in the CRE Markets

The FDIC has maintained a balanced supervisory approach that identifies problems and seeks corrections when there are weaknesses, while remaining sensitive to the economic and real estate market conditions and the efforts of bank managements. As federal supervisor for more than 5,000 community banks, the FDIC is well aware that bank lending is critical to our economy, and we share Congress' and the public's concern for making credit available on Main Street and working with borrowers experiencing difficulties. In response, on November 12, 2008, the FDIC joined the other federal banking agencies in issuing the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, which encourages banks to continue making loans available to creditworthy borrowers and to work with mortgage borrowers that have trouble making payments.

Our examiners, who are part of their local communities, are especially aware of the economic conditions and of the important role of bank lending.   Bank examiners have an important responsibility to perform a thorough, yet balanced asset review during our examinations, with a particular focus on concentrations of credit risk. Our efforts have focused on evaluating the effectiveness of banks' commercial real estate (CRE) loan underwriting, credit administration, portfolio management and stress testing, proper accounting, and the appropriate use of interest reserves. We expect that banks will have policies and practices in place to ensure these fundament aspects of prudent CRE lending are employed. The FDIC issued a Financial Institutions Letter in March 2008 titled *Managing CRE Concentrations in a Challenging Environment* that emphasized the importance of these tenets. This Letter followed up on the December 2006 joint *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,* which reminded institutions that strong risk management practices and appropriate levels of capital were essential elements of a sound commercial real estate lending program.

The FDIC also monitors changes in a bank's condition between examinations by following-up on significant issues and analyzing financial reports. ADC loans and other CRE loans are necessarily a significant focus of our examinations and have been for some time.

At the same time, the FDIC provides banks we supervise with considerable flexibility in dealing with customer relationships and managing loan portfolios. We do not instruct banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated or is otherwise clearly warranted for a safety and soundness reason. Write-downs on assets to "fire-sale" or liquidation values would generally be contrary to regulatory guidance.

The FDIC has heard from a number of small businesses and trade groups about difficulties they are having obtaining credit or renewing loans for existing credit relationships. The FDIC also has heard concerns that bank examiners are instructing banks to curtail lending or criticizing loan relationships where collateral values have declined, making it more difficult for consumers and businesses to obtain credit or roll over otherwise performing loans. This is not the case. FDIC examiners focus on borrowers' repayment sources, particularly their cash flow, as the means of paying off loans. Collateral is a secondary source of repayment and should not be the primary determinant in extending or refinancing loans.

The FDIC understands that businesses rely on banks to provide credit for their operations, and those extensions of credit will be essential in stimulating economic growth both in Georgia and across the country. Accordingly, we have not instructed banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or deny a refinance request solely because of weakened collateral value. To the contrary, through the 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (CRE Workout Guidance), FDIC has encouraged prudent and pragmatic CRE workouts within the framework of financial accuracy, transparency, and timely loss recognition. The FDIC expects banks to work with commercial borrowers who remain creditworthy despite some deterioration in their financial condition. This interagency guidance should help banks in Georgia and across the county become more comfortable extending and restructuring loans, which will help businesses and expedite a much-awaited economic recovery. At the same time, we recognize that the economic environment for real estate continues to be stressed, and we expect that banks will continue to accurately recognize losses in a timely manner in accordance with generally accepted accounting and financial reporting standards.

Finally, we believe that financial reform proposals currently under consideration could play a role in mitigating the types of risk that have led to significant losses in the Atlanta market. For example, the increased availability of subprime and nontraditional mortgages inflated the demand for housing and fueled unsustainable increases in residential development activity in the Atlanta area. Mortgage credit was offered by lenders without strong underwriting based on an ability to repay, and without strong rules against abusive lending practices and a meaningful examination and enforcement presence. Mortgage loans were underwritten in a manner that stripped individual and family wealth and undermined the foundation of the economy.

The FDIC believes that consideration of a borrower's ability to repay is a fundamental consumer protection that should be enforced across the lending industry. Establishment of such a standard at the Federal level should eliminate regulatory gaps between insured depository institutions and non-bank providers of financial products and services by establishing strong, consistent consumer protection standards across the board.

In addition, we support the creation of a process to oversee systemic risk issues, develop needed prudential policies and mitigate developing systemic risks. With the benefit of hindsight, it is fair to say that during the years leading up to the crisis, systemic risks were not identified and addressed before they were realized as widespread industry losses. The experience in Atlanta provides an example. During the years of rapid ADC loan growth, local financial institutions and their supervisors did not fully appreciate the growing risks posed by subprime and nontraditional mortgage originations. Examples such as this underscore the benefit of monitoring systemic risk to assess emerging risks using a system-wide perspective.

Conclusion

We understand the significant challenges faced by banks and their borrowers in the Atlanta real estate market. Accordingly, the FDIC has joined with other federal financial institution regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties both in Atlanta and across the country. Community banks in Georgia will play a critical role in helping local businesses fuel economic growth, and we support their efforts to make good loans in this challenging environment.

Thank you. I am pleased to answer any questions from members of the Panel.